Island Tel

ANNUAL REPORT 1986

THE ISLAND TELEPHONE COMPANY LIMITED

87-03810/

E.H. Duvar, Chairman of the Board and Chief Executive Officer (left); D.R. Livingstone, President and Chief Operating Officer (right).

REPORT HIGHLIGHTS

	1986	1985	% Change
Operating Statistics (Thousands)			
Revenues	$ 35 939	$ 32 916	9.2
Expenses	24 213	21 790	11.1
Net Income Applicable to Common Shares	4 103	3 940	4.1
Construction Program Expenditures	15 424	12 883	19.7
Telecommunications Property	120 769	107 530	12.3
Financial Statistics			
Earnings per Common Share	$ 3.02	$ 3.00	0.7
Dividends Declared per Common Share	$ 1.84	$ 1.80	2.2
Return on Average Common Equity	14.2%	15.1%	(6.0)
Return on Average Invested Capital	12.3%	12.7%	(3.1)
Equity per Common Share, December 31	$ 22.09	$ 20.57	7.4
Average Common Shares (Thousands)	1 358	1 315	3.3
Debt Ratio, December 31	48.2%	45.9%	5.0
Other Statistics			
Network Access Services, December 31	54 678	52 816	3.5
Long Distance Messages (Thousands)	8 239	7 560	9.0

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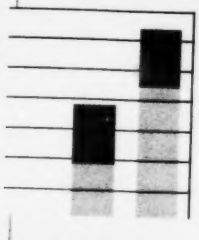

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THE FRONT COVER: This year Island Tel introduced a service improvement called Zero-Plus to most subscribers in France Island having new equipment called TOPS (Traffic Operator Position System). The TOPS equipment, featured on the cover, allows customers to dial their own operator-handled calls, reducing the amount of time an operator spends on each call increasing efficiency and reducing the time required to connect the call.

ACKNOWLEDGEMENTS: Island Tel wishes to extend sincere thanks to all those who assisted in the research and compilation of material for this annual report, and to the employees and others whose photographs appear throughout these pages: Carol Ann Boswell, Ross Clinton, Isabell Collins, Bob Hamilton, Bernard MacIntyre, Roger Meek, Rick Neale, Richard Nesbitt, Roger Nolan, Dave McLean, Mary Power, Gaynor Wood.

ANNUAL MEETING: The annual general meeting of the shareholders will be held at 11 a.m., March 26, 1987 at Island Tel's head office, 69 Belvedere Avenue, Charlottetown, PEI. Shareholders are invited to take part in the meeting and to vote on matters [illegible]

EXECUTIVE REPORT

To the Shareholders:

Rapidly developing telecommunications services contributed to the strong growth experienced by Island Tel over the past year, resulting in a 9.2 percent increase in revenues over 1985. The strong demand for basic telephone services, combined with the Company's marketing thrusts, resulted in continued growth in all aspects of our business.

Business Development

The growth in basic telephone service continued and 1,862 main telephone lines (known in the industry as network access services) were added in 1986, bringing the total number of lines in service to 54,678 at year-end, an increase of 3.5 percent over year-end 1985. During the year the Company also continued to show strong growth in both on- and off-Island long distance calling, with total long distance calls up 9.0 percent and resulting long distance revenue of $19.0 million, up 11.4 percent over 1985 results.

Another contributor to increased revenue growth in 1986 was Touch Tone service. A strong sales effort capitalized on the ever increasing popularity of this service feature continuing its expansion in the past year. By year-end, 38 percent of rental telephones were Touch Tone, as compared to just 15 percent five years ago.

Island Tel continues to be the principal supplier of telecommunications equipment and services in Prince Edward Island. With careful product planning and proactive sales efforts, we have been able to expand our business equipment market as well as non-traditional areas such as mobile and data communications. We are now in our fourth year of a competitive terminal equipment environment, and the Company continues to be the supplier of choice for virtually all business communications systems in Prince Edward Island.

Mobile and data communications are also rapidly growing contributors to the growth in overall company business. In particular, the recently introduced direct dial paging services exceeded sales forecasts for the year, resulting in a 10.2 percent growth in paging revenues. Also, with active sales efforts again this year, the Company continued to develop data communications services, and DATApac service was expanded to the Summerside area.

Network Expansion

The growth in the Company's business has required the continued expansion of our telecommunications network. Total capital expenditures for the necessary facility construction in 1986 were $15.4 million, compared to $12.9 million spent in 1985. With the anticipated continuing growth of the Company, construction expenditures are expected to total $30 million in the 1987-88 period.

The Company is expanding its telecommunications network utilizing the most cost efficient technology available to meet customers' growing service needs. Cable, switching and terminal facilities were added throughout the Company's exchanges in the past year, and two major construction projects to provide increased long distance calling capability were completed in 1986.

A major digital microwave radio and fibre optics system was constructed to accommodate the growth in both on- and off-Island long distance calling. The new system not only utilizes two of the newest technologies, digital microwave and fibre optics, it integrates them into one system allowing information to be transmitted over long distances more clearly and efficiently than older technology systems.

A second product was the installation of a digital long distance switch in Charlottetown also to accommodate expansion in the long distance network. Associated with this new DMS 200 digital switching equipment, the Company added facilities to provide for customer dialing of operator handled calls and direct dialing overseas calls. The total cost of this combined project is $7.9 million of which $5.5 million was spent in 1986.

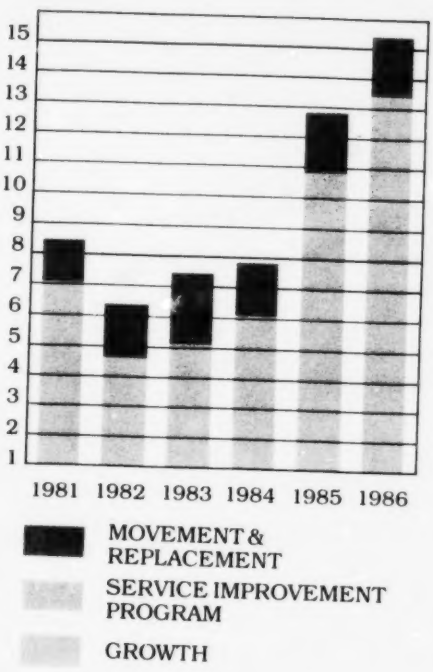
Changes in Operations

During the year major operating changes were made in two areas of the Company. New computerized systems were introduced in the business offices and in long distance operations to improve service to our customers and to reduce operating costs.

In the past year Island Tel began to phase in a company-wide integrated business system called SORDACS (Service Order Distribution and Control System). With SORDACS, orders and inquiries about services, phone listings and billings can be handled more efficiently because it enables the Company's service representatives to electronically access customer files and create service orders via computer terminals. With the elimination of considerable paperwork, SORDACS will save Island Tel thousands of dollars in long-term paper processing costs.

CONSTRUCTION PROGRAM

(Millions of Dollars)



The DMS 200 digital switch, which was installed this year for additional long distance switching, also laid the ground work for a service improvement called Zero-Plus dialing. This provides subscribers throughout most of PEI with the ability to direct-dial operator assisted calls such as collect, person-to-person and time and charge calls, making them faster, more convenient and more efficient than ever before. The new equipment also provides direct dialing to overseas countries, making overseas calling as simple as any other long distance call.

Island Tel, as a responsible employer, recognized that the conversion to the new equipment would reduce the requirement for telephone operators. Through careful planning of employee requirements, potentially displaced employees were retrained and, largely through attrition, were placed in other work within the Company.

Financial Results

Island Tel experienced the sixth consecutive year of growth in earnings per average common share despite an increase in the number of shares currently issued. Total operating revenues for 1986 were $35.9 million, up 9.2 percent over 1985, and earnings per average common share increased to $3.02 from $3.00 one year ago.

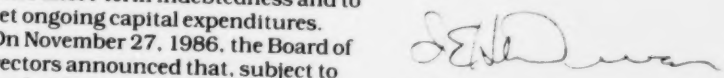
Return on average invested capital was 12.3 percent, as compared to 12.7 percent last year and return on average common equity was 14.2 percent, as compared to 15.1 percent one year ago. While net earnings available to common shareholders continued to grow in 1986, the additional shareholders' equity from the Dividend Reinvestment Plan and the Employees' Stock Savings Plan resulted in reduced investment returns. With the trend towards decreasing costs of capital and reduced utility earnings, we expect the Company's 1986 return on investment to compare favourably with other companies in the industry.

In 1984 the Public Utilities Commission for the province of Prince Edward Island provided a range for an allowed return on common equity of 15.0 to 15.5 percent. On October 7,1986 the Commission directed Island Tel to file evidence in February 1987 for public hearings to be held later in the spring. These hearings will review the Company's permitted rate of return, operating expenses and revenue requirements.

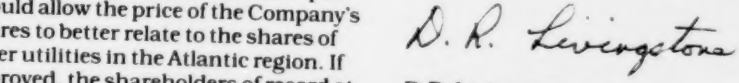
The continuing growth in basic telephone service, plus increases in long distance calling, have combined to create a requirement for increased capital expenditures. On March 14,1986 the Company issued $4 million of first mortgage bonds. The proceeds from this issue were used principally to reduce short-term indebtedness and to meet ongoing capital expenditures.

On November 27, 1986, the Board of Directors announced that, subject to shareholder approval at the annual general meeting on March 26, 1987, the Company will split its common shares on a two-for-one basis. The share split should allow the price of the Company's shares to better relate to the shares of other utilities in the Atlantic region. If approved, the shareholders of record at the close of business on April 6, 1987 will receive, on or before April 16, 1987, one additional share for each share held.

During 1986 the Company continued to develop and grow. The reason for this steady development is that our customers are making ever increasing use of our many and varied telecommunications services. The Company is committed to using the most cost effective technology to provide for our customers' growing and changing needs. As we look to the future, providing quality service to customers and a satisfactory return on the shareholders' investment will continue to be the cornerstones of Island Tel's operation.



I.E.H. Duvar
Chairman of the Board
and Chief Executive Officer

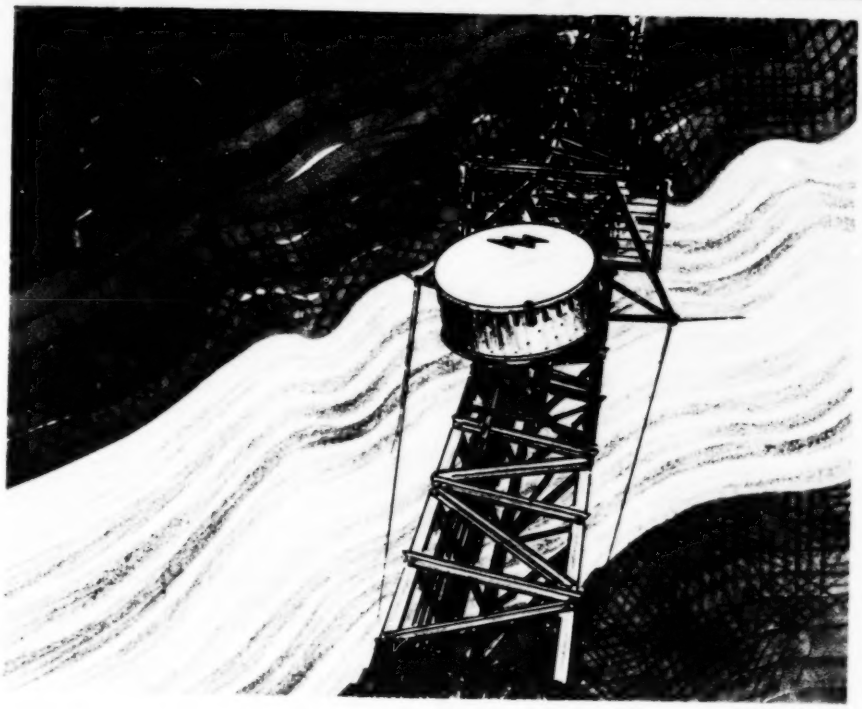


D.R. Livingstone
President and
Chief Operating Officer

THE TRILLIUM 6-16

It's Island Tel's electronic telephone set for small to mid size businesses. With time-saving features like last number redial, paging and speed call, the Trillium can be easily upgraded as needs grow. The Trillium 6-16: with 6 lines, 16 extensions — and unlimited possibilities.

Millview: Island Tel's Microwave Milestone



On any given day, a busy telephone executive might call his counterpart in almost any region of Canada. But when Island Tel President Don Livingstone telephoned the president of B.C. Tel last May, his call was anything but ordinary.

On May 29, 1986, Island Tel entered a new era in telecommunications history as President Livingstone made the first official call over the Company's new high capacity, digital microwave installation in Millview, PEI. While the Millview facility is Island Tel's second microwave system for off-Island calls, it is the first one to use digital technology.

Island Tel has combined digital microwave technology and fibre optics into one system to expand its capacity for long distance voice and data telecommunications. The addition of the new Millview facility to its long distance network means the Company can increase the capacity and improve the quality of off-Island communications.

As we plan for the next decade in telecommunications services, long distance voice communications will remain an important source of revenues while the Company pursues emerging opportunities in data communications.

The telephone's ability to access a growing field of information sources makes it a more powerful tool than ever before. Every day more companies, government agencies and independent business people are investing in computer-related communications systems, like electronic mail and on-line information retrieval. These rapidly growing services rely on

5 New Ways to Get the Phone

SIGNATURE

BASIC TELEPHONE

GE9160

Backed by planning and market research, in 1986 Island Tel broadened its range of residential phone products.

Our Signature Touch Tone set is a popular rental model with residential and single-line business customers. The Signature offers convenience features like last number redial, a six number memory and a visual "ringer".

In 1986 the Company introduced a new line of consumer products:

uniform, dependable and cost effective communications networks. That's why telecommunications customers everywhere are using Island Tel's DATAroute, DATApac and Envoy 100 data communications services.

Millview underlines Island Tel's commitment to meet our customers' needs in voice and data communications. The new facility is a major element in Island Tel's multi-million dollar long distance network connecting the microwave facility in Millview via a 25 km optical fibre cable to Charlottetown. Here at Island Tel's main switching office a computerized digital switching unit — the DMS 200 — switches long distance messages to telephone exchanges throughout the province. The addition of the Millview facility and its link to the DMS 200, enhances Island Tel's ability to meet a diversified, expanding market for long distance services.

By combining digital microwave and fibre optics technologies, Millview offers major advantages over conventional telecommunications.

Fibre optics use bursts of laser light to send messages through fine glass strands, in much the same way that copper wires carry electrical pulses. Yet not only are fibre optic cables smaller and lighter than conventional cable, they can carry far more information faster, more economically and with higher signal quality and reliability than conventional circuitry.

Today, just one pair of these glass fibres (each about the thickness of a human hair) can carry 12 television channels, 565 megabytes of computer data or thousands of simultaneous voice conversations. As fibre optic technology continues to develop, Island Tel can further expand the message capacity of its Millview facility.

Fibre optics have other important communications benefits. Unlike copper wires, they are unaffected by electrical interference or by "crosstalk" from adjoining wires, thereby improving line quality. Because of their durability and lower maintenance costs, fibre optics represent a significant saving in upkeep and repair.

Millview's digital microwave system has its own advantages over conventional radio transmission. The digital signal means Island Tel can transmit greater volumes of information with higher quality, ensuring we can meet our customers' long distance needs as they grow.

Yet Island Tel's newest digital-optical link is more than just a high-tech "information pipeline". In the increasingly competitive telecommunications industry, customers expect their telephone company to reach for the future. The addition of Millview to the existing microwave system signals that Island Tel has a vision for the future and the technology, skills and commitment to start building that future today.

Island Tel

TELEPHONE ANSWERING MACHINE
GE9880

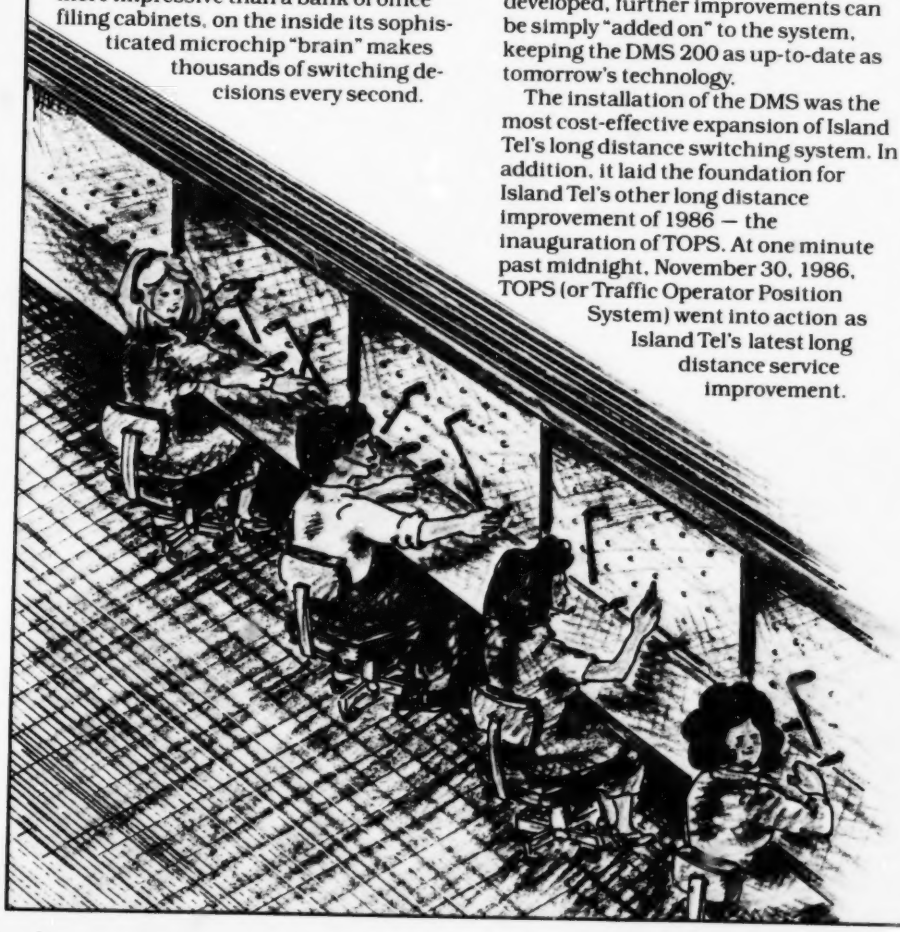
GE9270
FEATURED TELEPHONE

3102
CORDLESS TELEPHONE

BRINGING TOPS TO LONG DISTANCE CALLING

During 1986, Island Tel invested nearly $5.5 million in two new major long distance facilities that together will make our telecommunications services more reliable, more efficient and more cost effective than ever before. By linking a digital multiplex switch, the DMS 200, with Island Tel's new province-wide, computer-assisted operator system called TOPS, the Company is ready to serve an expanding market for long distance service both on- and off-Island.

The first stage in this complex upgrading project was the installation of the DMS 200 — a computerized digital long distance switching machine that has dramatically changed conventional telephone switching. The DMS 200 switch was installed to meet the continuing growth in long distance in PEI and has improved capabilities for voice switching and data communications. And while the DMS may look no more impressive than a bank of office filing cabinets, on the inside its sophisticated microchip "brain" makes thousands of switching decisions every second.



Operators at Island Tel's new TOPS positions can handle operator-assisted calls more efficiently than before because calls are dialed by subscribers and billing information, which was recorded manually, is now keyed into a computer keyboard.

The DMS is more compact than electromechanical switching machines, and by replacing the electromechanical components with microchip technology, the DMS 200 reduces the cost of systems operations. As new DMS software is developed, further improvements can be simply "added on" to the system, keeping the DMS 200 as up-to-date as tomorrow's technology.

The installation of the DMS was the most cost-effective expansion of Island Tel's long distance switching system. In addition, it laid the foundation for Island Tel's other long distance improvement of 1986 — the inauguration of TOPS. At one minute past midnight, November 30, 1986, TOPS (or Traffic Operator Position System) went into action as Island Tel's latest long distance service improvement.

Thanks to the combination of TOPS and DMS, Island Tel's long distance customers can now take advantage of two new services: Direct Dialing Overseas and Zero-Plus dialing. The new feature means that Island Tel customers can dial their own person-to-person, collect, calling card and third-number billed calls, simply by dialing zero, plus the number. That makes most operator-assisted calls as fast and easy to place as direct distance dialed calls.

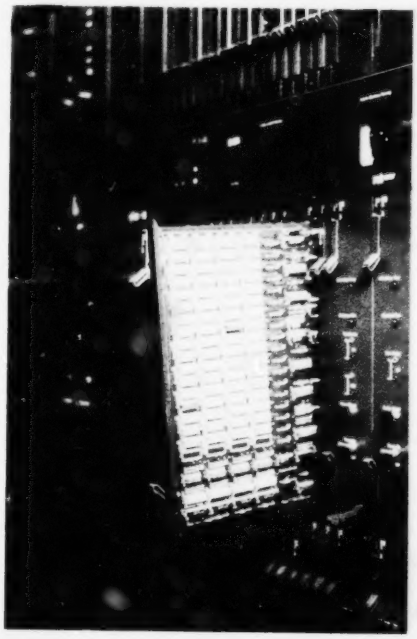
Island Tel's growing market for overseas calling will also benefit from the TOPS-DMS installation. Now with Direct Dialing Overseas (or DDO), customers in most of PEI can dial direct to more than 75 overseas countries. Before the DDO improvement, overseas calls had to be transferred from PEI to operators in either Montreal or Vancouver for final transmission.

As an operator system that has already proven its reliability and effectiveness in the Canadian telecommunications industry, TOPS will improve the effectiveness of Island Tel's long distance service by saving operator work time and improving operator efficiency.

Before the changeover to TOPS, the work time for an operator-assisted long

distance call included the time for operators to cord-connect calls and manually record billing information. Now an operator can handle those same tasks electronically through a TOPS computer keyboard, considerably reducing work times. With 15,000 long distance calls passing through TOPS every day, this improvement represents a significant saving in time and labour.

Island Tel's changeover to these service improvements wasn't accomplished overnight. Two years of planning, design, installation and testing were invested in the TOPS-DMS conversion. Throughout the project, Island Tel employees worked hard to maintain uninterrupted customer service — no easy feat when one considers equipment modifications were required in every telephone exchange. Today, through that combination of human expertise and the right technology, Island Tel can better serve an important, growing market for long distance calling.



The DMS 200, a computerized digital switching unit, is more compact than electromechanical switching machines. As new DMS software is developed, further improvements can be "added on" to the system, keeping the DMS 200 as up-to-date as tomorrow's technology. Each tray in the unit holds switching software for the long distance network.

BUSINESS SYSTEMS SALES MAKE GAINS IN 1986

As PEIs provincial government complex switches over to centralized business service, reaching people in government will be easier. These buildings, which are part of the complex, are located two blocks west of Charlottetown's central office.

By almost any measure, 1986 was a year of marketing success for Island Tel. The strong market performance of Island Tel's business communications equipment demonstrated that telephone products represent the leading edge in information technology.

But it wasn't just the hardware that sold our customers on Island Tel. Sales and service representatives worked hard to provide the kind of client support that has built the Company's reputation for service. That combination of new technology and customer support resulted in strong business sales in government, educational, retail and medical sectors.

One of the success stories of 1986 was the marketing of Island Tel's Centralized Business Service (Centrex) to the Charlottetown offices of the provincial government. Converting the government's existing telephone arrangements to the service will greatly improve both public access to government offices and internal telephone calling by replacing the many departmental switchboards with one unified telephone system. With the new system, outside calls can be dialed in directly and are easily transferred from one department to another, and internal calls can be made by dialing just four numbers.

Work on the change-over began near the end of 1986. With approximately 160 government telephones converted in Charlottetown by year-end and a total of about 1,200 Charlottetown telephones to be changed over to the service, this project will continue into 1988 as a phased conversion.

Island Tel's clients in the educational, retail and medical sectors also produced strong market demand in 1986. In the spring, the Company won the tender to construct, wire and install the telephone and data communications network for the new Atlantic Veterinary College complex. The college will be linked with the existing SL1 service at the University of PEI, and approximately 160 new lines will be added by Island Tel over a three year period.

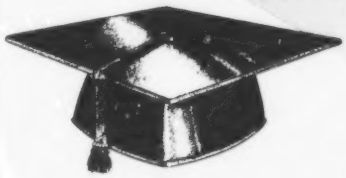
A major retail system sale to the Charlottetown branch of Sears was another marketing success for Island Tel. Working in close consultation with Sears' Toronto headquarters, Company staff designed a "first-time" telecommunications package in PEI, installing a new electronic switchboard with an internal automatic call distributor system. A strong selling point of this new telephone technology is that the call distributor feature can be combined with Sears' computerized order/inventory system to improve customer service.

Island Tel was also successful in winning the 1986 tender to provide phone service for Charlottetown's Polyclinic medical facility. After carefully discussing the individual communications needs of the Polyclinic, the Company provided a customized telephone system to meet the special needs of the medical operations.

These four examples highlight some of the major business systems sales in 1986. In addition, Island Tel had a good response to its province-wide sales campaign to customers for new small business communications systems, surpassing forecasted sales.

Successful marketing of commercial telecommunications systems needs more than an aggressive sales team. Ongoing service and support are essential, and Island Tel's marketing gains during 1986 underlined our Company's growing reputation for state-of-the-art products and individual customer service.

A COMMITMENT TO EMPLOYEE DEVELOPMENT



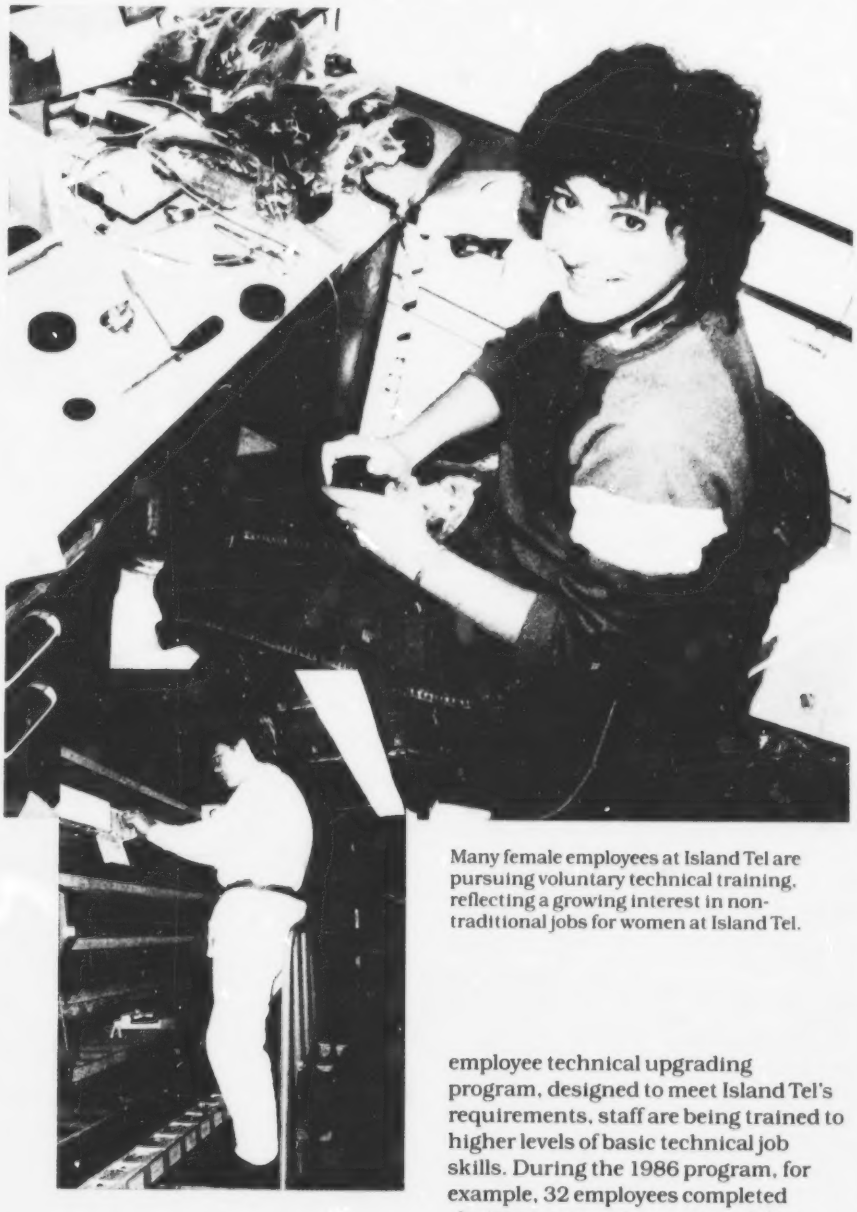
Island Tel understands that investing in advanced telecommunications systems calls for continuous employee job training and skill upgrading. That commitment to developing job skills among employees was clearly demonstrated in 1986. To meet upgraded service requirements, Island Tel provided more training than ever before with nearly 2,000 person-days of instruction.

This was largely due to the implementation of two new computer-based systems at Island Tel. SORDACS (or Service Order Distribution and Control System) was the first of these systems to come on stream. The second major development was the computerized operator system known as TOPS. A large number of employees had to be trained for these systems.

SORDACS is designed to improve the efficiency of order processing in Island Tel's business offices by replacing the traditional paper-based service order system with computerized files. Prior to the inauguration of the new system, management and staff received two weeks of training in SORDACS learning to create, access and transmit customer orders electronically.

The installation of the TOPS system also meant extensive training, this time for most of Island Tel's operators. "Hands on" training in the new system was provided in two stages during August and September. Using a computerized TOPS simulator, operators learned how to electronically "connect" long distance calls via the new system.

Not all of Island Tel's training programs during 1986, however, were strictly tied to new technology. A new customer relations program was taught as part of Island Tel's ongoing commitment to effective customer service.



Many female employees at Island Tel are pursuing voluntary technical training, reflecting a growing interest in non-traditional jobs for women at Island Tel.

Nearly half of the employees took the special two-day course in 1986, and the program will continue in 1987. Instead of the traditional classroom lecture approach, the course used textbooks, audio visual materials and discussion groups to teach employees how to deal more effectively with the broad range of Island Tel customers.

In the telecommunications industry, the introduction of new technology means job responsibilities are continually evolving. Under a special employee technical upgrading program, designed to meet Island Tel's requirements, staff are being trained to higher levels of basic technical job skills. During the 1986 program, for example, 32 employees completed electronics courses as a part of this program.

In addition, the Company has made available voluntary technical training to further upgrade employee skills improving employment opportunities. Staff are encouraged to enroll in job-related courses through the voluntary, out-of-hours educational assistance program. Under this program, Island Tel reimburses 75 percent of an employee's tuition costs. In 1986, a total of 53 employees took courses through the educational assistance

Training was provided for the introduction of SORDACS, an integrated business system being phased into the Company over the next two years.

program. Job related courses like word processing and basic electricity were well attended. Female employees comprised about one third of those taking basic electricity reflecting a growing interest in non-traditional jobs for women.

As part of the Company's commitment to employees, Island Tel provides retraining where technological change may mean a reduced need for staff. When the 1986 changeover to TOPS resulted in a surplus of operators, career counselling was offered through the co-operative efforts of Holland College and Island Tel. A number of employees were trained for other employment, and through effective human resource planning, no regular full-time employees were laid off.

As business philosophies and communications technology keep evolving, Island Tel will continue to support training/retraining as an investment in its most important resource — its employees.

SPOTLIGHT ON HEALTH AND SAFETY

Regular safety audits are conducted with all outside plant employees as part of Island Tel's company-wide accident prevention plan.

Health and safety have always been important concerns for Island Tel. In 1986, the Company expanded its efforts in its safety programs. A major assignment during the year was the Accident Prevention Audit. The Audit was conducted to determine how the Company's work environment could benefit from more attention to safety.

The safety audit was an important step in Island Tel's 1986 campaign to establish a company-wide Accident Prevention Plan. This attention to safety on the job produced positive results in 1986. While Island Tel lost 204 person days due to accidents in 1985, this year only three person days were lost due to on-job accidents.

Ensuring employees' health and physical fitness is just as important as safety on the job. Since 1983, Island Tel has supported an Employee Assistance Program which directs employees and their families with health, financial or personal problems to available community services. During 1986, Island Tel also conducted a number of voluntary diagnostic and educational programs, including smoking cessation, stress management and lower back safety. In addition, health monitoring tests provided employees with hearing, vision and blood pressure check-ups.

Increased participation in health testing and counselling programs points to the fact that Island Tel employees want to live healthier lifestyles and to be more physically and mentally alert.

In October, for the third consecutive year, the Company set aside a special week of "Health and Safety Days" to spotlight safety in the workplace and at home. During the week, five Island Tel employees were recognized for their 20 years of accident-free driving, and additional awards went to 76 other employees for safe driving, totalling 886 years of safe driving on behalf of Island Tel.

Island Tel recognizes that a good safety record isn't built on rules alone. Safety in the workplace depends on employees being well trained in their jobs and in accident prevention. With the inauguration of its Accident Prevention Plan in 1986, Island Tel is working hard to make health and safety an everyday part of operations.

1986 A YEAR IN REVIEW

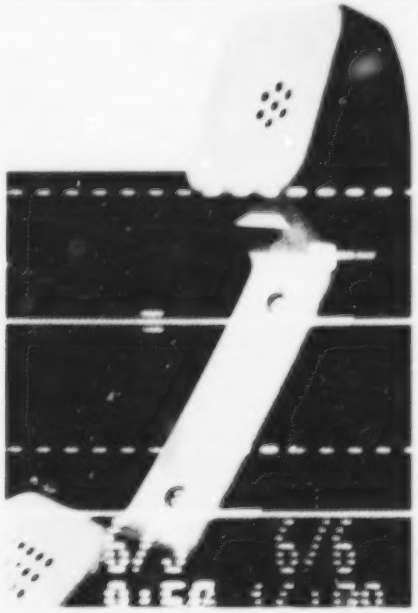
SORDACS

The computer revolution has triggered the rise of the "paperless office". With the installation of SORDACS in 1986, the age of high-tech office systems has come to Island Tel.

SORDACS (or Service Order Distribution and Control System) enables Island Tel's service representatives to electronically access customer files and create service orders via computer terminals. With SORDACS, inquiries about services, phone listings and billings can be handled more efficiently.

Under the earlier manual system, service representatives had to search through central files for customer contracts, fill out memos or service orders and then distribute them. SORDACS eliminates much of the time-consuming labour by electronically accessing, revising and distributing orders.

This computerized system will result in greater productivity and improve cost effectiveness. And by eliminating tedious paperwork, SORDACS will save



Island Tel thousands of dollars in long-term paper processing costs.

During 1986, phase one of SORDACS was installed in the Company's business offices. By 1988, SORDACS will be completely phased in as a company-wide integrated business system.

As Island Tel's customer base grows in the future, SORDACS will have the capacity to meet increasing demands in the most effective manner.

ISLAND TEL WELCOMES NEW DIRECTOR

At a meeting on July 25, 1986, the Island Tel Board of Directors elected Donald R. Livingstone as a Director of the Company. Since joining the Company in 1952, Mr. Livingstone has assumed progressively senior positions, becoming General Manager in 1973, Vice President and General Manager in 1979, and President and Chief Operating Officer of Island Tel in June 1986. Mr. Livingstone's appointment follows a resolution to expand the Company's Board of Directors passed at Island Tel's annual meeting in March 1986. To allow for the increased Board, the Company's Act of Incorporation was amended by the Legislative Assembly of Prince Edward Island on July 18, 1986.

CLEAN AIR POLICY *"CLEANS UP"*

In 1986, Island Tel became the first company in Prince Edward Island to implement a successful Clean Air Policy. The Policy is based on the recognition that the Company is responsible for establishing and maintaining a safe, healthy working environment for all employees.

The Clean Air Policy was introduced in three stages. During the initial phase between January and March, employees were encouraged to designate personal work spaces as non-smoking areas. In the second phase, between April and the end of August, smoking on Island Tel premises was permitted only in special areas of Company lunch rooms.

The final phase began in September with a company-wide employee attitude survey to determine long range plans for the Clean Air Policy. The survey found that both smoking and non-smoking employees support the maintenance of the current designation of smoke-free areas. They have also requested the provision of properly ventilated and separate designated areas for those who smoke. Separate breakrooms will be established in Island Tel buildings as regularly scheduled renovations take place. In addition, Island Tel will continue to provide a series of in-house smoking cessation programs.

In recognition of its achievement in establishing a smoke-free work place, Island Tel was awarded a Certificate of Merit by the P.E.I. Division of the Canadian Heart Foundation.

LONG DISTANCE CONTEST:

TERRIFIC TOLL TOPPER

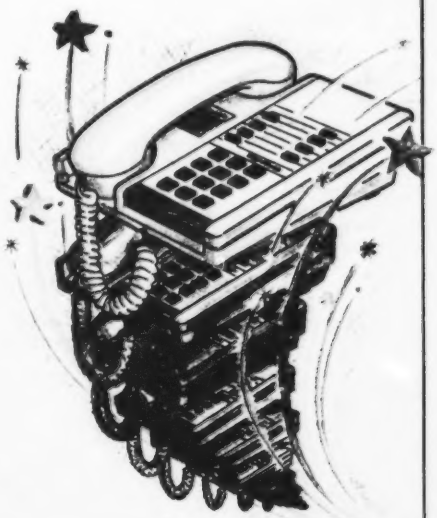
During September and October 1986, Island Tel sponsored a "Glad I Called" long distance car contest in conjunction with NB Tel and Maritime Tel & Tel.

Public response in PEI to the contest was overwhelming. Island Tel received over 41,200 entries during the eight-week campaign, far exceeding the 17,000 PEI entries during Telecom Canada's 1985 long distance contest.

The resulting growth in Island Tel's long distance tolls was equally impressive. The number of long distance messages rose 9.0 percent over the previous year.

To stimulate long distance use, the "Glad I Called" contest awarded three 1987 Ford Tempos as prizes, one in each Maritime province. Publicity for the contest included a special television commercial, bill inserts and displays in Island Tel business offices.

"BARGAIN MONTH" BONANZA



Even before the campaign had ended, Island Tel's popular "Bargain Month" promotion during November and December exceeded all expectations, as customers throughout PEI exchanged their rented rotary-dial phones for the latest Touch Tone models from Island Tel.

By the end of the five week promotion, conversions had climbed to 158 percent of forecasted totals. More than 3,000 subscribers switched to Touch Tone service, increasing Island Tel's Touch Tone market from 35 percent in 1985 to 38 percent at year's end, 1986.

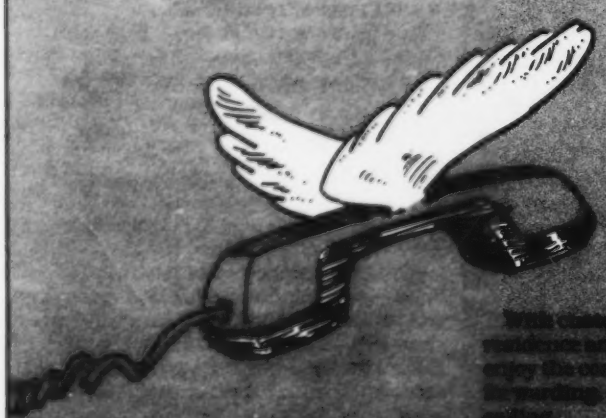
Why was the promotion so successful even in the face of stiff retail competition in the residential phone market?

One reason is that Island Tel has established a strong reputation for reliable, top-quality telephone equipment. Another factor is that the 1986 promotion was extended to a brand new market. In the past, Island Tel's Touch Tone promotions have only included residential customers. In 1986, however, the Company extended the campaign to single line business phones as well.

The 1986 "Bargain Month" also offered our customers new products, like the Signature telephone set, and new services, like custom calling.

Through successful promotions like "Bargain Month", Island Tel is committed to developing the growing Island market for single line products and services.

CUSTOM CALLING



Island Tel is committed to marketing a full range of communication services. In 1986, the Company introduced a new package of telephone services known as custom calling features.

With custom calling, single-line residence and business customers enjoy the convenience of call forwarding, call waiting, speed calling, [illegible]

numbers, including direct dialed long distance, into your telephone. Then, one or two numbers is all you need to complete the call.

Call forwarding lets you transfer incoming calls to another designated number within the local calling exch[illegible]ge. For people on the go, call forwarding means you don't have to miss that important telephone call.

Custom calling's call waiting feature will alert you to an incoming call while you're already on the phone with a beeping signal only you can hear. Simply pressing the switchhook puts your first caller on hold allowing you to answer that incoming call. Island Tel's initial marketing of custom calling features in 1986 was to three exchanges, 367, 566 and 888. As this useful service package is offered in additional exchanges, Island Tel's single-line customers can customize their telephone into a powerful communications tool.

DATA TRANSMISSION "TAKES OFF"

VetNet, CBA-Net and iNet may sound like a fisherman's tools of the trade, but they are all part of Island Tel's high-tech data communications networks that in 1986 experienced a 40 percent growth in usage over 1985 levels.

To handle the increased traffic in electronic data communications during the year and to meet local data communications needs, Island Tel added DATApac service in the Summerside area. Now customers can also access these data transmission networks through public dial-in "ports". As a result of this expansion, the Company added two major customers to its growing list of DATApac subscribers, Loomis Couriers and Big Wheels Transport, whose Kensington-based operation reaches to central Canada and the U.S. Eastern seaboard.

1986 was also a year of new demand for Envoy 100 electronic mail service. This demand has been encouraged by Island Tel's ongoing series of marketing demonstrations, displays and exhibits. Another stimulus to growth is the rapid increase in specialized data services, such as CBA-Net. This Envoy based electronic mail service, developed by the Canadian Bar Association, is attracting strong interest from the PEI legal profession.

In the years ahead, Island businesses, government agencies and educational institutions will find new applications for Island Tel's rapidly growing data services such as DATApac, DATAroute, Envoy and iNet. As the province's principal provider of data communication services, Island Tel will be ready to serve those emerging markets.

"YEAR OF THE PAGER"

At Island Tel, they're calling 1986 "the year of the pager". The Company enjoyed its most successful promotion ever for the popular "dial-a-page" service.

A 30 day advertising promotion last spring produced nearly a three-fold increase in demand over a similar promotion in 1985. As part of the May 1986 campaign, Island Tel offered the first month of pager service free if customers rented a pager for a minimum of three months. Not only did the "three for the price of two" incentive bring in new business, the vast majority of customers continued to rent their pagers after the promotion.

One reason for the success of the campaign and overall growth in demand was the emergence of a new market for pager service. Nurses, building contractors and shift workers were just some of the customers who found pagers to be very practical. Receiving just one important phone call could save them enough money to pay for the pager rental.

In 1986, Island Tel's pager rentals broke the 900 mark, representing an increase of 16 percent over 1985. To keep up with the projected growth in demand, Island Tel expanded its paging terminal in April to accommodate the increased demand.

Island Tel is the major provider of telecommunications services throughout the province of Prince Edward Island. At the end of 1986, Island Tel had 54,678 network access services (main telephone lines) throughout 26 exchanges, serving a population of 128,200 across the province. As a member of Telecom Canada, the Company is an active participant in the national telecommunications system and provides access to a broad range of voice, data and other telecommunications services.

Island Tel is regulated by the Public Utilities Commission for the province of Prince Edward Island. Until 1976, a majority of the Company's common shares were owned by Maritime Telegraph and Telephone Company, Limited (MT&T). Currently, MT&T remains the largest common shareholder with 38.1 percent of the issued and outstanding common shares. Of Island Tel's 1,500 holders of common shares, 28.8 percent are residents of PEI and the remaining are dispersed across Canada and abroad. Shares are traded on the Montreal Exchange and the Toronto Stock Exchange.

As of December 31, 1986, Island Tel had 307 full-time, permanent members in its workforce. In the past year, Island Tel paid $9 785 200 in payroll to its employees. In addition, the Company contributed on behalf of its employees: $919 800 in payments to the non-contributory pension plan; $224 900 in payments for Unemployment Insurance; $402 200 in total benefits payments; and $124 500 in payments to the Canada Pension Plan.

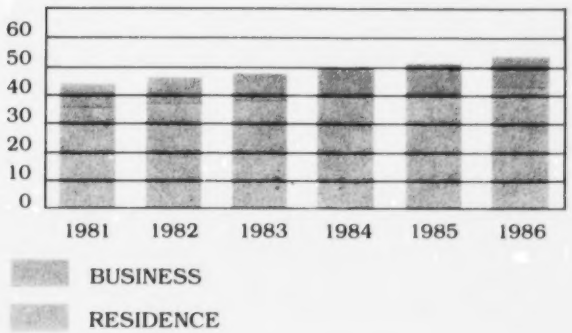
The retirement of James L. Cameron, Outside Plant and Network Services Manager was announced in December 1986 after almost forty years of service to the Company. Mr. Cameron joined Island Tel as a Central Office Apprentice in 1947 and over the years has served in a number of senior positions with Island Tel. He was also the Company's Assistant Secretary since 1973.

Also in December, an organizational change was announced to come into effect in January 1987. With the evolving demands for growth and service in the Company, the organization has been structured into three major departments: the Customer Services Department, under the direction of David W. McLane, General Manager,

FINANCIAL REVIEW

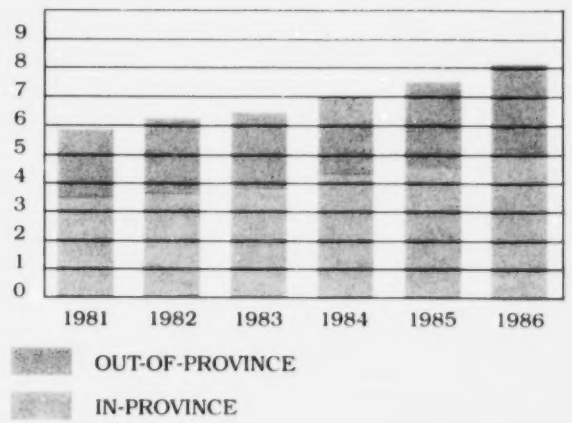
NETWORK ACCESS SERVICES

(Thousands)



LONG DISTANCE MESSAGES

(Millions)



Customer Services; the Network Services Department, under the direction of Bernard P. MacIntyre, General Manager, Network Services; and the Corporate Services Department, under the direction of Ronald L. Waite, Corporate Services Manager. These organizational changes are designed to allow the Company to effectively provide for the continued expansion and increasing sophistication of our Company.

The Company experienced steady growth in the demand for telecommunications services in 1986 and, as a result, there were substantial gains in all classes of revenues, especially those of long distance and local service.

Earnings

Earnings per average common share for 1986 increased to $3.02 as compared to $3.00 in 1985. Earnings available for common dividends increased to $4.1 million from $3.9 million in 1985, however, the increase in average common equity has reduced the rate of return on that equity to 14.2 percent, down from last year's 15.1 percent.

In November the Board of Directors decided that, at the annual general meeting to be held in March, shareholders will be asked to approve a two-for-one split of the Company's common shares.

Operating Revenues and Expenses

Operating revenues for the year were $35.9 million, a 9.2 percent increase over 1985. Local service revenues increased by 5.8 percent, the result of strong growth in Network Access Services. Long distance messages increased by 9.0 percent, resulting in an increase in total long distance revenues of 11.4 percent. The increase in "miscellaneous" revenues of 16.1 percent included revenues received from the outright sale of equipment (net of cost), of directory advertising and directory sales.

Operating expenses (excluding depreciation) increased by 9.2 percent while depreciation expense increased by 16.0 percent, caused in large part by the placing in service of the major digital long distance switch in the Charlottetown central office.

Net income of $4.6 million was 3.7 percent over that of 1985, and after payments of $483 000 to holders of preference shares and $2.5 million to common shareholders, a balance of $1.6 million was reinvested in plant and equipment. Shareholders' common equity at year-end amounted to $30.8 million, a growth of 11.9 percent over 1985, and equity per common share was $22.09, an increase of 7.4 percent over last year's $20.57.

Financing and Capital Structure

On March 14, 1986, the Company issued $4 million of 11.25 percent First Mortgage Bonds, Series Q, to mature on March 15, 2006, and at an issue price of $99.50, the Bonds provided a yield of 11.31 percent to the purchaser. A further $1.7 million was raised by the sale of 56 076 common shares under the terms of the Company's stock plans during the year. Proceeds from these issues were used principally to reduce short term indebtedness and to meet ongoing capital expenditures.

At year-end, the Company's debt ratio was 48.2 percent, and the common equity component of the capital structure was 43.1 percent. On January 29, 1987, the Common Shareholder Dividend Reinvestment Plan was cancelled, to be effective following the next issue of shares on March 15, 1987.

The Company expended $15.4 million on capital programs during 1986 and, with a common equity ratio projected to reach 45 percent in 1987, has established a firm financial base for the planned capital expenditures of over $30 million in the period 1987-1988.

FINANCIAL REVIEW

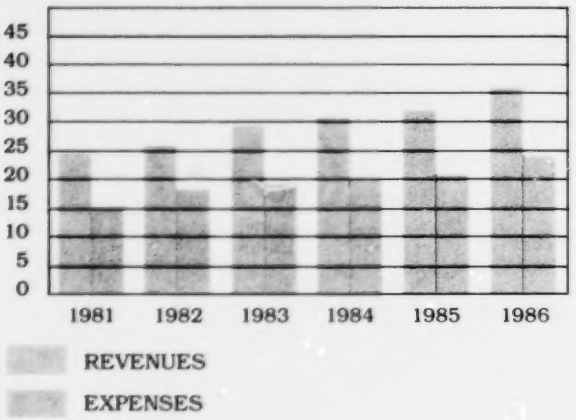
(continued)

Regulatory Matters

On October 7, 1986, the Public Utilities Commission for the province of Prince Edward Island directed Island Tel to file evidence in February 1987 for public hearings to be held later this spring. These hearings will review the Company's permitted rate of return, operating expenses and revenue requirements.

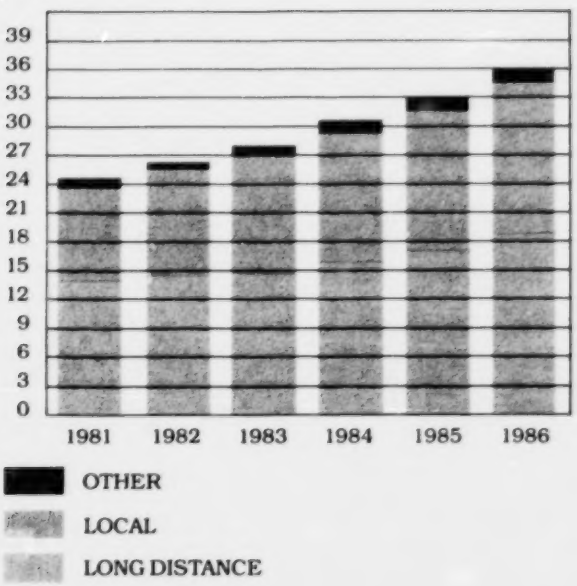
REVENUES VERSUS EXPENSES

(Millions of Dollars)



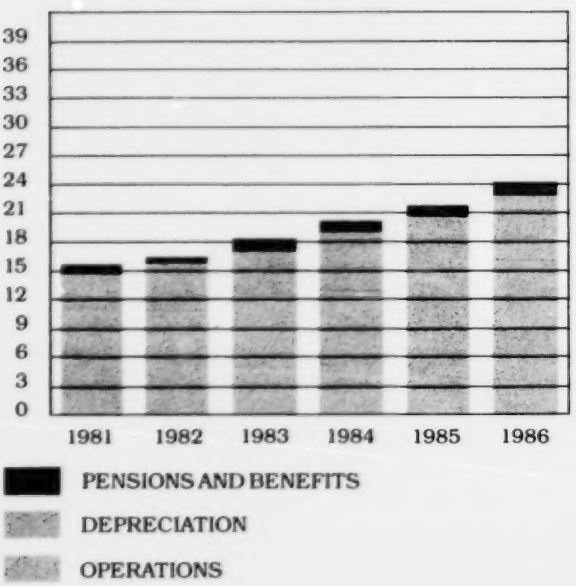
REVENUES

(Millions of Dollars)



EXPENSES

(Millions of Dollars)



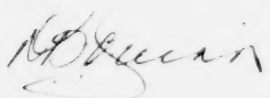
MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

The financial statements have been prepared by management, which is responsible for the integrity and objectivity of this information. The statements have been prepared in conformity with generally accepted accounting principles and, where appropriate, include amounts based on management's estimates. Financial information elsewhere in this Annual Report is consistent with that in the financial statements.

The Company has a system of internal accounting controls designed to provide reasonable assurance that transactions are recorded and executed in accordance with its authorizations, that assets are properly safeguarded, and that reliable financial records are maintained.

Clarkson Gordon, Chartered Accountants, the external auditors appointed by the shareholders, are engaged to provide an independent audit of the financial statements. Their report is presented on this page.

The Audit Committee of the Board of Directors, comprised entirely of outside Directors, meets periodically with management, the internal auditors and the external auditors to discuss audit and financial matters. In addition, this committee reviews the annual financial statements of the Company and submits its report to the Board of Directors. The financial statements are submitted to the Board for approval.



Donald B. Quinn
Vice President (Finance)

AUDITORS' REPORT

To The Shareholders of
The Island Telephone Company Limited

We have examined the financial position statement of The Island Telephone Company Limited as at December 31, 1986 and the statements of income, retained earnings and cash flow for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these financial statements present fairly the financial position of the company as at December 31, 1986 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Chartered Accountants

Halifax, Canada
January 30, 1987

INCOME STATEMENT

For the Year Ended December 31	1986 $	1985 $
REVENUES		
Local service	15 530 400	14 674 500
Long distance service	18 959 600	17 024 300
Other, net of uncollectible revenues	1 448 700	1 217 200
	35 938 700	32 916 000
EXPENSES		
Depreciation	7 240 400	6 242 000
Operating including maintenance	11 876 000	10 686 800
General and administrative	3 974 200	3 593 000
Pensions and benefits	1 122 400	1 268 400
	24 213 000	21 790 200
	11 725 700	11 125 800
OTHER INCOME		
Allowance for funds used during construction	552 200	202 000
Other	(35 000)	206 600
	12 242 900	11 534 400
INTEREST AND OTHER DEBT EXPENSES (Note 2)	3 804 100	3 261 700
	8 438 800	8 272 700
INCOME TAXES	3 853 300	3 850 000
NET INCOME	4 585 500	4 422 700
Preference dividends	483 000	483 000
NET INCOME APPLICABLE TO COMMON SHARES	4 102 500	3 939 700
EARNINGS PER COMMON SHARE	3.02	3.00

See accompanying notes

RETAINED EARNINGS STATEMENT

For the Year Ended December 31	1986 $	1985 $
BALANCE AT BEGINNING OF YEAR	12 645 800	11 083 300
ADDITIONS		
Net income	4 585 500	4 422 700
Other	1 400	3 300
	4 586 900	4 426 000
DEDUCTIONS		
Preference dividends	483 000	483 000
Common dividends	2 503 600	2 376 300
Capital stock expenses	3 700	4 200
	2 990 300	2 863 500
BALANCE AT END OF YEAR	14 242 400	12 645 800

See accompanying notes

FINANCIAL POSITION STATEMENT

As at December 31	1986 $	1985 $
ASSETS		
TELECOMMUNICATIONS PROPERTY		
Buildings, equipment and facilities in service	117 986 900	101 114 100
Less accumulated depreciation	39 522 000	34 093 200
	78 464 900	67 020 900
Land, and property under construction	2 211 500	5 676 000
Construction materials inventory	570 200	740 500
	81 246 600	73 437 400
INVESTMENTS (Note 3)	110 800	110 800
CURRENT ASSETS		
Cash	267 400	266 300
Accounts receivable	5 143 500	4 457 400
Prepayments	656 400	432 900
	6 067 300	5 156 600
DEFERRED CHARGES		
Unamortized long-term debt expenses	295 700	251 700
Other deferred charges (at cost)	440 600	379 500
	736 300	631 200
	88 161 000	79 336 000
LIABILITIES AND SHAREHOLDERS' EQUITY		
SHAREHOLDERS' EQUITY		
Common stock (Note 4)	6 978 900	6 698 500
Premium on common stock (Note 5)	9 615 600	8 212 100
Retained earnings	14 242 400	12 645 800
	30 836 900	27 556 400
Preference stock (Note 4)	6 250 000	6 250 000
	37 086 900	33 806 400
LONG-TERM DEBT (Note 6)	28 600 000	28 100 000
CURRENT LIABILITIES		
Due to Maritime Telegraph and Telephone Company, Limited	405 100	351 400
Accounts payable	2 076 200	3 466 300
Income taxes payable	–	176 100
Interest accrued	825 100	693 300
Debt due within one year (Note 7)	5 860 100	532 700
Other current liabilities	1 618 000	1 337 400
	10 784 500	6 557 200
DEFERRED CREDITS		
Income taxes	11 684 400	10 872 400
Other deferred credits	5 200	–
	11 689 600	10 872 400
	88 161 000	79 336 000

See accompanying notes

On behalf of the Board

Ivan E.H. Duvar
Director

Horace R. MacFarlane
Director

CASH FLOW STATEMENT

For the Year Ended December 31	1986 $	1985 $
OPERATING ACTIVITIES		
Net income	**4 585 500**	4 422 700
Non-cash items		
Depreciation	**7 240 400**	6 242 000
Deferred income taxes	**812 000**	464 400
Allowance for funds used during construction	**(552 200)**	(202 000)
Amortization of long-term debt expenses	**34 400**	31 400
Other, net	**1 300**	3 300
Change in operating working capital (Note 9)	**(2 009 700)**	1 049 900
CASH PROVIDED BY OPERATING ACTIVITIES	**10 111 700**	12 011 700
FINANCING ACTIVITIES		
Common shareholder dividend reinvestment plan	**1 259 300**	404 100
Employees' stock savings plan	**424 600**	373 600
Dividends	**(2 986 600)**	(2 859 300)
Increase in bank and other notes	**1 827 400**	532 700
Long-term debt	**4 000 000**	5 000 000
Repayment of long-term debt	**—**	(3 400 000)
Other, net	**(76 900)**	(74 500)
CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	**4 447 800**	(23 400)
INVESTING ACTIVITIES		
Construction program expenditures	**15 424 200**	12 882 800
Increase (decrease) in construction materials inventory	**(170 300)**	145 200
Deduct charges not requiring cash outlay	**(756 500)**	(336 700)
Cash used for construction	**14 497 400**	12 691 300
Other, net	**61 000**	(96 900)
CASH USED IN INVESTING ACTIVITIES	**14 558 400**	12 594 400
INCREASE (DECREASE) IN CASH AND TEMPORARY CASH INVESTMENTS	**1 100**	(606 100)
BALANCE AT BEGINNING OF YEAR	**266 300**	872 400
BALANCE AT END OF YEAR	**267 400**	266 300

See accompanying notes

NOTES TO FINANCIAL STATEMENTS

1. **Summary of Significant Accounting Policies**

(a) ***System of accounts:***

The Company is subject to regulation, including examination of accounting practices, by the Public Utilities Commission for the Province of Prince Edward Island. The system of accounts and accounting practices are similar to those being used by other companies in the telecommunications industry.

(b) ***Telecommunications property:***

Telecommunications property is recorded at cost.

Construction materials inventory consists of items which will be used in the construction program.

Depreciation is charged on a straight-line basis using rates for classes of property, determined by a continuing program of engineering studies, as approved from time to time by the Public Utilities Commission for the Province of Prince Edward Island. These rates provide for depreciation of the assets over their estimated service lives and resulted in an average rate for 1986 of 6.9% (1985, 6.6%).

(c) ***Income taxes:***

Deferred tax accounting has been followed with respect to all timing differences. Income tax expense is based on income reported in the Income Statement. The Company defers the payment of a portion of the income tax expense in arriving at taxable income by deducting certain expenses in amounts greater than are charged in the Income Statement. Taxes deferred in this manner appear in the Financial Position Statement as a deferred credit.

(d) ***Allowance for funds used during construction:***

The Company is allowed a return on capital invested in new telecommunications property while under construction by including an "allowance for funds used during construction" as an addition to the cost of the property constructed. The allowance is calculated using a rate based on the cost of equity and the after tax cost of debt.

(e) ***Unamortized long-term debt expenses:***

Unamortized long-term debt expenses are being amortized on a straight-line basis over the duration of the various debt issues.

(f) ***Earnings per common share:***

Earnings per common share are computed based on the average of the average number of shares outstanding each month during the year.

2. **Interest and Other Debt Expenses**

	1986	1985
	$	$
Interest on long-term debt	**3 595 300**	3 199 700
Amortization of long-term debt expenses	**34 400**	31 400
Interest on bank and other notes	**96 000**	7 200
Interest on deposits held	**78 400**	23 400
	3 804 100	3 261 700

3. **Investments** — includes investment, at cost, in miscellaneous physical property ($50 800) and shares of Telesat Canada ($60 000). There is no quoted market value for Telesat Canada; however, its book value is greater than the Company's original cost.

4. **Capital Stock**

		1986	1985
Authorized:		$20 000 000	$20 000 000
Issued:	Shares Outstanding at Jan. 1, 1986	Issued For Cash	**Shares Outstanding at Dec. 31, 1986**
Common, par value $5.00	1 339 700	56 076	1 395 776
Preference			
4½% par value $10.00	40 000		40 000
4¾% par value $10.00	40 000		40 000
5½% par value $20.00	37 500		37 500
7¼% par value $20.00	75 000		75 000
9¼% par value $20.00	100 000		100 000
9¼% par value $20.00 (1977 Series)	60 000		60 000
	352 500		352 500
Total Issued	1 692 200	56 076	1 748 276
Value at par, of issued common and preference shares	$12 948 500	$280 400	$13 228 900

The Company has a Common Shareholder Dividend Reinvestment Plan whereby holders of common shares have the option to acquire additional common shares at a discount of 5% of market price through the reinvestment of dividends. Participants may also purchase, to a maximum of $3 000 per quarter, additional common shares at market price. For the year 1986, the Company reserved 75 000 shares and during the year issued 43 402 shares for $1 259 300 under the terms and conditions of the Plan. (Also see Note 12, Subsequent Event)

For the year 1986, the Company reserved 25 000 common shares for issuance under the Employees' Stock Savings Plan and during the year issued 12 674 shares for $424 600 to employees under the terms and conditions of the Plan. These shares are generally issued in December of each year after the completion of twelve months of contributions at a purchase price equivalent to market price.

Preference shares

All series are cumulative, redeemable and are non-voting unless eight quarterly dividends are in arrears.

4½%, 4¾%, and 5½% Preference shares

The Company may redeem the shares at any time upon giving thirty days notice to the holders, at par plus a stated premium in each case and any accrued but unpaid dividends.

7¼% Preference shares

The Company may redeem all or part of the outstanding shares at a premium of $0.60 if redeemed before June 15, 1987, the premium thereafter decreasing $0.20 every three years until June 15, 1990.

9¼% Preference shares

The Company may redeem all or part of the outstanding shares at a premium of $1.05 if redeemed before June 15, 1988, the premium thereafter decreasing $0.20 every three years until June 15, 1997.

9¼% Preference shares — 1977 Series

The Company may redeem all or part of the outstanding shares at a premium of $1.25 if redeemed before April 15, 1988, the premium thereafter decreasing $0.20 every three years until April 15, 2000.

NOTES (continued)

5. **Premium on Common Stock**

	1986	1985
	$	$
Beginning of year	8 212 100	7 574 200
On shares issued during year	1 403 500	637 900
End of year	9 615 600	8 212 100

6. **Long-Term Debt**

Series	Rate	Maturing	1986 Principal	1985 Principal
			$	$
O	15¾%	October 1, 1987	—	3 500 000
G	7⅜%	February 1, 1988	1 000 000	1 000 000
H	8 %	December 15, 1991	3 000 000	3 000 000
I	9¼%	December 15, 1993	4 000 000	4 000 000
*J	11 %	January 15, 1995	100 000	100 000
K	11 %	March 31, 1996	2 500 000	2 500 000
L	10⅜%	June 1, 1997	2 500 000	2 500 000
M	10⅜%	December 1, 1998	2 500 000	2 500 000
P	12¾%	January 31, 2000	5 000 000	5 000 000
N	14 %	October 15, 2000	4 000 000	4 000 000
Q	11¼%	March 15, 2006	4 000 000	—
			28 600 000	28 100 000

*The holders of $3 400 000 of the original principal amount of $3 500 000 of Series J Bonds exercised their right and elected to retract their holdings at par on January 15, 1985.

The Bonds, except for Series O, are redeemable at the option of the Company prior to maturity at various premiums to a maximum of 14%. Redemptions cannot be made if the funds borrowed for refunding purposes have an interest cost that is less than the interest cost of the Bonds redeemed, except in the last five years prior to maturity.

The Bonds are secured by a Deed of Trust and Mortgage and by deeds supplemental thereto containing a first fixed and specific mortgage, pledge and charge upon all real and immovable property of the Company and a first floating charge on all other property, both present and future of the Company.

7. **Debt Due Within One Year**

	1986	1985
	$	$
Bank and other notes	2 360 100	532 700
First mortgage bonds, Series O, 15¾% due October 1, 1987	3 500 000	—
	5 860 100	532 700

Debt due within one year is normally refinanced out of the proceeds of longer term financing. This amount is included in total capital in computing capitalization ratios and rates of return on capital.

8. **Pension Fund** — pension fund obligations are accounted for and paid over the estimated future working lifetime of employees of the Company. The contribution to the pension fund for the year ended December 31, 1986 amounted to $919 800 (1985, $939 700). The actuarial review as of December 31, 1985, based on earnings and service to that date, show that all vested benefits are fully funded.

NOTES (continued)

9. **Change in Operating Working Capital**

Cash provided by (used in) changes in operating working capital components:

	1986	1985
	$	$
(Increase) decrease in accounts receivable	(686 100)	(224 100)
(Increase) decrease in prepayments	(223 500)	24 300
Increase (decrease) in due to Maritime Telegraph and Telephone Company, Limited	53 700	75 600
Increase (decrease) in accounts payable	(1 390 100)	1 273 400
Increase (decrease) in income taxes payable	(176 100)	(295 400)
Increase (decrease) in interest accrued	131 800	94 200
Increase (decrease) in other current liabilities	280 600	101 900
	(2 009 700)	1 049 900

10. **Related Party Transactions** — Maritime Telegraph and Telephone Company, Limited owns 38.1% (1985, 37.2%) of the Company's issued common shares.

During the year the Company paid $4 193 000 (1985, $3 389 000) to the Maritime Telegraph and Telephone Company, Limited for the supply of certain management, administrative, engineering and other operations support services. Also included in this amount is $1 849 000 (1985 $1 578 000) for the purchase of materials, supplies and telecommunications property.

11. **Dominant Industry Segment** — the Company operates in the telecommunications industry, providing telephone, data and a wide range of telecommunications services throughout Prince Edward Island.

12. **Subsequent Event** — on January 29, 1987, the Company approved the discontinuance of the Common Shareholder Dividend Reinvestment Plan effective March 16, 1987.

YEARS IN REVIEW

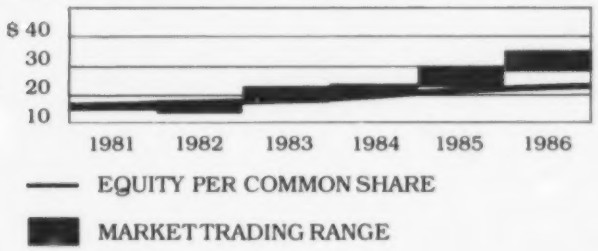
	1986	1985	1984	1983	1982	1981
Financial Position at December 31 (Thousands)						
Telecommunications property	$ 120 769	$ 107 530	$ 96 161	$ 89 849	$ 84 555	$ 79 937
Accumulated depreciation	39 522	34 093	29 396	25 215	22 410	19 176
Investments	111	111	111	111	111	111
Current assets	6 067	5 157	5 563	4 487	4 999	3 739
Deferred charges	736	631	712	713	835	590
Shareholders' equity	37 087	33 806	31 466	29 405	27 606	26 024
Long-term debt	28 600	28 100	23 100	26 500	26 500	23 750
Current liabilities	10 784	6 557	8 175	4 020	4 602	6 726
Deferred credits	11 690	10 873	10 410	10 020	9 382	8 701
Income (Thousands)						
Revenues						
Local service	$ 15 530	$ 14 675	$ 13 452	$ 12 656	$ 11 486	$ 9 939
Long distance service	18 960	17 024	15 958	14 608	14 299	13 984
Other, net of uncollectible revenue	1 449	1 217	1 124	1 002	687	530
	35 939	32 916	30 534	28 266	26 472	24 453
Expenses	24 213	21 790	19 976	18 160	16 604	15 580
Other income	517	409	270	255	204	225
Interest and other debt expenses	3 804	3 262	3 034	3 067	3 028	2 813
Income taxes	3 853	3 850	3 579	3 400	3 349	2 972
Net income	4 586	4 423	4 215	3 894	3 695	3 313
Financial Statistics at December 31						
Equity per common share	$ 22.09	$ 20.57	$ 19.22	$ 18.07	$ 17.08	$ 16.14
Embedded debt cost	11.6%	11.6%	11.3%	11.3%	11.2%	10.5%
Capital structure						
Debt (including short term)	48.2%	45.9%	45.7%	47.8%	49.7%	50.9%
Preference equity	8.7%	10.0%	10.8%	11.1%	11.4%	11.8%
Common equity	43.1%	44.1%	43.5%	41.1%	38.9%	37.3%
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Financial Statistics for the year						
Earnings per common share	$ 3.02	$ 3.00	$ 2.90	$ 2.72	$ 2.62	$ 2.35
Dividends declared per common share	$ 1.840	$ 1.800	$ 1.710	$ 1.610	$ 1.560	$ 1.485
Return on average common equity	14.2%	15.1%	15.5%	15.6%	15.8%	14.8%
Average common shares (Thousands)	1 358	1 315	1 285	1 252	1 225	1 202
Return on average invested capital	12.3%	12.7%	12.7%	12.6%	12.6%	12.0%
Return on earnings base	10.4%	10.6%	10.5%	10.4%	10.5%	10.1%
Times bond interest earned–before taxes	3.4	3.6	3.6	3.5	3.9	3.7
Times total interest charges earned–before taxes	3.2	3.5	3.6	3.4	3.3	3.2
Interest and preference dividend coverage	2.6	2.8	2.8	2.6	2.6	2.4
Other Statistics at December 31						
Network access services						
Residence	43 148	41 971	40 903	39 659	38 654	37 832
Business	11 530	10 845	9 768	9 036	8 343	7 186
	54 678	52 816	50 671	48 695	46 997	45 018
Total Company telephones	83 973	81 676	78 029	75 029	72 843	69 727
Employees	307	296	299	289	293	305
Telecommunications property per network access service	$ 2 209	$ 2 036	$ 1 898	$ 1 845	$ 1 799	$ 1 776
Other Statistics for the year						
Long distance messages (Thousands)						
In-province	4 974	4 570	4 262	3 927	3 781	3 576
Out-of-province	3 265	2 990	2 743	2 500	2 383	2 278
	8 239	7 560	7 005	6 427	6 164	5 854
Construction program expenditures (Thousands)	$ 15 424	$ 12 883	$ 7 935	$ 7 491	$ 6 242	$ 8 530
Salaries and wages (Thousands)	$ 9 785	$ 8 865	$ 8 080	$ 7 373	$ 7 022	$ 6 593

INFORMATION FOR SHAREHOLDERS

	1986	1985
Number of holders of common shares at December 31	1 500	1 500
Number of common shares outstanding at December 31	1 365 776	1 339 700
Distribution of shareholders		
Prince Edward Island	28.6%	28.7%
Other Canadian	70.5%	70.4%
Other	0.9%	0.9%
	100.0%	100.0%
Volume of common shares traded		
Toronto Stock Exchange	120 044	123 070
Montreal Exchange	29 641	3 566
	149 685	126 636
The Toronto/Montreal Exchanges		
Price ranges (high-low)		
First quarter	$29¾-27¾	$24¾-22
Second quarter	30¼-27¾	27 -24⅛
Third quarter	32 -29¾	27 -25¼
Fourth quarter	34 -31⅛	29¼-25⅜

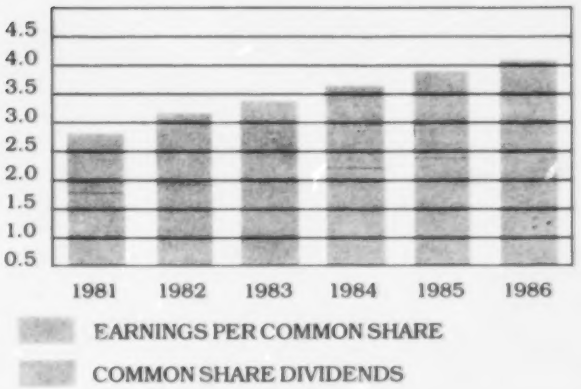
Valuation Day Prices (December 22, 71)	
Common shares	$10.25
4¼% Preference shares	$ 6.25
4¾% Preference shares	$ 6.60
5¼% Preference shares	$15.25

EQUITY PER COMMON SHARE AND MARKET TRADING RANGE



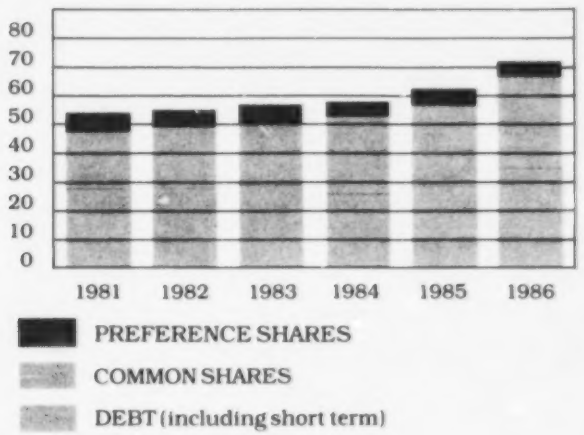
COMMON SHARE EARNINGS

(Millions of Dollars)



CAPITAL STRUCTURE

(Millions of Dollars)



Investor Inquiries

Mailing Address:

The Island Telephone Company Limited
Investor Services
P.O. Box 820
Charlottetown, PEI
C1A 7M1

Telephone:
1-800-565-7168
(toll free in Canada and the U.S.)

Facsimile:
902-429-8755

Dividends

Quarterly dividends were paid on March 15, June 16, September 15 and December 15 of 1986. Common dividends paid amounted to $0.46 for each of the four quarters. The total dividends paid per share in 1986 was $1.84, an increase of $0.04 over the 1985 annual rate.

Stock Listings

The Company's common stock is listed on the Toronto Stock Exchange and the Montreal Exchange under the symbol IT. Information on daily stock prices and trading volumes is available in the Toronto and Montreal Exchange listings in most daily newspapers.

DIRECTORS & OFFICERS

THE ISLAND TELEPHONE COMPANY LIMITED
Incorporated under the laws of the Province of Prince Edward Island
Head Office: 69 Belvedere Avenue, P.O. Box 820, Charlottetown,
Prince Edward Island, Canada C1A 7M1 (902) 566-5501

DIRECTORS

* **Ivan E.H. Duvar**
Chairman of the Board and
Chief Executive Officer
The Island Telephone Company Limited
Charlottetown, P.E.I.

* **Walter C. Auld**
Vice Chairman of the Board
The Island Telephone Company Limited
Charlottetown, P.E.I.

** **Charles J. Fraser**
Director
The Island Telephone Company Limited
Charlottetown, P.E.I.

* **Glen H. Geldert, P.Eng.**
** Vice President Operations
Maritime Telegraph and Telephone
Company, Limited, Halifax, N.S.

** **John J. Howatt**
President
Darlington Farms Ltd., Darlington, P.E.I.

William Herbert C. Leavitt
President
The Leavitt's Maple Tree Craft
Alberton, P.E.I.

† **Donald R. Livingstone**
President and Chief
Operating Officer
The Island Telephone Company Limited
Charlottetown, P.E.I.

* **Horace R. MacFarlane**
** President
Prince Edward Island
Bag Company Limited
Summerside, P.E.I.

J. Norman MacLeod
President
Williams, Murphy & MacLeod
(1971) Ltd.
Charlottetown, P.E.I.

Alan K. Scales, Q.C.
Senior Partner
Scales, Jenkins and McQuaid
Charlottetown, P.E.I.

* Member Executive Committee
** Member Audit Committee
† Elected to the Board, July 25, 1986

OFFICERS

Ivan E.H. Duvar
Chairman of the Board and Chief
Executive Officer

Walter C. Auld
Vice Chairman of the Board

Donald R. Livingstone
President and Chief
Operating Officer

Donald B. Quinn
Vice President (Finance)

Roy A. Teal
Comptroller

A. Douglas Hartt
Secretary/Treasurer

James L. Cameron
Assistant Secretary
Retired December 31, 1986

OPERATIONS

D.W. McLane
Customer Services &
Administration Manager

R.E. Meek
Commercial Manager

B.P. MacIntyre
Marketing Manager

P.A. Acorn
Supervisor — Planning &
Operations Staff

R.L. Waite
Supervisor — Personnel &
Support Services

R.B. Read
Supervisor — Installation &
Repair

J.L. Cameron
Outside Plant & Network
Services Manager

C.M. McIntyre
Operator Services Manager

D.C. Rogers
Supervisor — Construction
and Building, Vehicles &
Supplies

A. Taylor
Supervisor — Trunks &
Switching

P.A. Trainor
Engineering Supervisor —
Outside Plant

REGISTRAR & STOCK TRANSFER OFFICES

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